No. 20915 and No. 20916

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

TIM W. LILLIE and INGEBORG V. LILLIE, husband and wife (Docket No. 20915) and PEARL LILLIE, an individual (Docket No. 20916),

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITIONERS' REPLY BRIEF.

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Preliminary Statement.

This reply brief is necessary to dispel the smoke-screen created by Respondent's brief.

To properly utilize the short time permitted for oral argument of this case, counsel for both parties and this Court must have a clear view of the points involved prior to hearing. Time and attention at the hearing must not be diverted to irrelevant cases and misstatements of the facts and the evidence.

I.

Respondent's Brief Cites Fourteen (14) Cases Which Are Irrelevant to Any Issue Before This Court.

Counsel for Petitioners has read and analyzed fourteen (14) cases cited in Respondent's brief which are not relevant to any issue before this Court. Time at

the hearing of this case should not be spent distinguishing them; therefore this reply brief must do so to assist the Court and permit the Court to focus its attention on the true purpose of the review—to see the errors and mistakes of the Tax Court below.

Respondent's brief (footnote 7 at p. 13) cites six (6) cases as having "considered" the point that the deposits for future services[1] cannot be deducted as expenses in the year of payment. Actually, the cases cited by Respondent are concerned with and hold the following:

1. *Main & McKinney Bldg. Co. v. Comm'er,* 113 F. 2d 81 (C.A. 5th), 40-2 USTC ¶9558.

   (Rental payment on 99 year leasehold)

   Taxpayer acquired a 99 year lease on real property in Houston, Texas, and attempted to deduct annual payments of rent as ordinary and necessary expense in the year of payment. The Court held that annual payments of rent constituted part of the cost of the leasehold rental payments and were not deductible in their entirety in the years of payment but should be recovered by deductions for exhaustion over the term of the lease.

2. *Baton Coal Co. v. Commissioner,* 51 F. 2d 469 (C.A. 3rd, 1961), 2 USTC ¶788

   (Bonus payments disguised as rental payments and capital expenditures)

   Taxpayer made bonus payments on lease of coal property and deducted as rental payments

[1]Respondent assumes the issue, as did the Tax Court below, that payments were deposits and that they were for "future" services and "future" purchases.

in year paid. Held: Payments were "bonuses paid in connection with the attaining of the lease" and should be capitalized and the cost recovered over the life of the asset [lease].

3. *Peters v. Commissioner,* 4 T.C. 1236, Dec. 14, 512

4. *Boylston Market Ass'n v. Commissioner,* 131 F. 2d 966 (1st Cir. 1942), 30 AFTR 512

(Prepaid insurance must be prorated)

These two cases deal with the question of whether or not a cash basis taxpayer can deduct prepayment of insurance premiums. The courts held that prepaid insurance, having a longer life than a taxable year, is a capital expense and should be allocated over the period of the insurance contract.

5. *Galatoire Bros. v. Lines,* 23 F. 2d 676 (C.A. 5, 1928)

(Advance rental payments covering 45 month lease must be amortized)

Taxpayer, a lessee for 45 months (3 years and 9 months) paying 50% of the profits from its business and boarding the lessor and his family during the first year of the lease, was required to prorate the total amount of rent over the life of the lease.

6. *Automatic Fire Alarm Co. v. Comm'er,* 13 BTA 1195, Dec. 4495.

(Advance payment for exclusive franchise)

Taxpayer made an advance payment for the exclusive right to purchase and sell certain

merchandise in certain cities. The court held that advance payments were not deductible in the year of payment where the advance was to be credited against merchandise purchases made in future years where taxpayer was not "required" to make any further purchases.

By citing the above cases, Respondent demonstrates the same lack of grasp of the issues in this case as the Tax Court demonstrated in its decision. Advance rental payment cases, prepaid medical expenses cases, prepaid insurance premium cases, and incorrect characterization of capital expenditure cases are inapplicable to the case at bar because they involve well-recognized exceptions to the general rule that an expense shall be deducted by a cash basis taxpayer in the year of payment. These exceptions have long been considered as a special kind of situation parallel to the amortization of capital expenditures.

Respondent's brief (footnote 8 at p. 13) cites *General Bancshares Corp. v. Com'r,* 326 F. 2d 712 (C.A. 8, 1964), 61-1 USTC ¶9920, as standing for the proposition that if "an amount is paid as a deposit against future expenses [again assuming the ultimate issue], it does not meet the test of deductibility." In that case the Court held that costs of issuing stock dividends must be capitalized. Any possible analogy between the case cited and the case at bar escapes counsel for Petitioners.

Respondent's brief (p. 14) cites seven (7) cases apparently concerned with the issues of "burden of proof" and "each case should be decided upon its own facts."

These cases are concerned with and hold as follows:

1. *Interstate Transit Lines v. Comm'r,* 319 U.S. 590 (CA-8, 1943), 43-1 USTC ¶9486.

   (Deductibility of expenses of illegal operation of subsidiary)

   Taxpayer, a Nebraska corporation, operated an interstate bus line between Illinois and California and did intrastate business in most of the states enroute. Because of its foreign incorporation, petitioner was barred under California law from doing intrastate business in California. In an attempt to circumvent the law, petitioner created a subsidiary in California which operated illegally and incurred a deficit which taxpayer attempted to deduct as an ordinary and necessary business expense. The Court held that the deficit was attributable to intrastate business of taxpayer's subsidiary in which taxpayer had no legal right to engage, was not deductible by taxpayer.

2. *E. & J. Gallo Winery v. Commissioner,* 227 F. 2d 699 (CA-9, 1956), 56-1 USTC ¶9101.

   (Carryover of unused excess profits credit under World War II Excess Profits Tax Law by surviving corporation of a merger)

   Taxpayer was the surviving corporation in a merger of corporations, the merged corporation of which had an unusued credit under the World War II Excess Profits Tax Law. The Court held that the surviving corporation may carry forward and deduct in subsequent years the unused credit of the merged corporation under the provisions of §701(c)(3)(B) of the 1939 Code.

3. *Comm'er v. Heininger,* 320 U.S. 467, 44-1 USTC ¶9109.

(Deductibility of attorney's fees and expenses of resisting a fraud order against taxpayer's business)

Attorney's fees and other expenses incurred by taxpayer in litigation pursuant to a fraud order instituted against him by the Post Office Department were held by the Supreme Court of the United States to be deductible from taxpayer's gross income, since the defense of his business and the expenses which it involved were ordinary and necessary within the meaning of §23(a) of the 1936 and 1938 Revenue Acts.

4. *Russell Box Co. v. Comm'er,* 208 F. 2d 452, 454; 54-1 USTC ¶9126 (CA-1, 1954)

(Items not deductible as expenses—wire mesh fence a capital expenditure; losses not deductible on sham sales)

The issues in this case were whether or not the cost of a wire mesh fence around taxpayer's plant was a deductible expense or a capital expenditure, whether an alleged sale of machinery to an employee of taxpayer's selling agent was a bona fide sale and a subsequent loss on the sale deductible, and whether or not the worthlessness of a bad debt had been established to make it deductible. The Court held that the wire mesh fence was a capital expenditure, that the worthlessness of the bad debt had not been established and therefore was not deductible, and that the alleged sale was not a bona fide sale and the loss on it was not deductible.

5. *Wohl v. U.S.,* 267 F. 2d 605 (CA-5, 1959), 3 AFTR 2d 1654 [*Rittenberg v. U.S.*]

(Expenditures by taxpayer on behalf of his corporation to obtain lease for corporation not deductible as rental payments or business expenses)

This case is actually known as *Rittenberg v. United States* and involves a taxpayer who made annual payments, personally, to an owner of an apartment house to induce the owner to lease the land to his corporation at $9,000.00 per year rather than $12,000.00 per year as the land owner demanded. The taxpayer deducted the annual payments made by him personally as a business expense. The Court held that the payments were in the nature of "capital contributions" by the taxpayer to the corporation and were not deductible by the taxpayer not only on the theory that the expenditures were made as capital contributions but also because they were made "on behalf of another".

6. *Wells-Lee v. Comm'r,* TCM 1964-315, 23 TCM Dec. 27073(M)

(Payments by osteopaths to hospital to secure staff privileges are not business expenses but capital expenditures)

This case involved three osteopaths who made payments to a hospital association to secure staff privileges to practice in hospitals owned by the association. The taxpayers deducted such payments as ordinary and necessary business expenses, but the Court held that they were not deductible as ordinary business expense but rather they were capital expenditures.

7. *Doyle v. Mitchell Brothers Co.*, 247 U.S. 179 (1918), 1 USTC ¶17 (CA-6, 1918).

   This 1918 case involves a lumber manufacturing corporation which owned certain timber lands which appreciated in value over the years. The issue was whether appreciation in value of assets prior to incidence of tax was taxable income on subsequent liquidation, and the Court held that it was not.

Petitioners submit that the cases cited above are irrelevant to the issues at bar and hesitate to suggest why they have been cited in Respondent's brief.

II.

Respondent's Brief Contains Misstatements of Important Facts and the Evidence.

Respondent's brief contains several misstatements of facts and the evidence which are so vital in this case that such reckless statements could prejudice a fair review of Petitioner's appeal if not pointed out to this Court prior to the hearing. Petitioners specify the following gross misstatements:

1. Respondent charges (p. 17) that Petitioners failed to report the sale of feed back to McCabe in the so-called "refund" incident of 1961 as income in that year [and cites Ex. 8-H]. The reviewing agent, appellant staff, counsel for Respondent below and the Tax Court were all aware that the money received by Petitioners from McCabe in 1961 is included as income in the item identified as "sale of cattle" on the

schedule of farm income in the 1961 returns of Petitioners. Counsel for Respondent at this level *could have* and *should have* ascertained this fact before including such accusation in its brief.[2]

2. Respondent states (brief p. 18) that "a substantantial portion of the end-of-year payments was for services to be rendered in the subsequent year", yet neither Respondent nor the Tax Court below have any evidence, testimony or idea of what portion of the cost of feed constituted "services" and what portion constitutes "ingredients".

3. Respondent's statement (p. 15) that "[all] customers of Heber and McCabe *could* pay monthly for the cost of feed consumed . . ." is simply untrue. The evidence is uncontroverted that Petitioners' binding agreement with Heber and McCabe was to pay in advance.

By copying the language of the Tax Court decision in its brief, Respondent has compounded the errors and mistakes which occasion this appeal.

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[2]This Court may be assured that the tax audit conducted by the District Director of Internal Revenue in this case did NOT leave $26,140.57 and $14,382.74 of overstated cost of feed in 1960 or understated income in 1961 unaccounted for until this point in the proceedings to be suddenly "discovered" by counsel for Respondent.

Conclusion.

Petitioners submit that because counsel for Respondent was granted extra time within which to prepare the government's brief, it seems only fair that, prior to the hearing of this case, this Court should consider Respondent's citation of so many irrelevant cases and inclusion of misstatements of facts.

Respectfully submitted,

CHARLES A. PINNEY, JR.,
Attorney for Petitioners.

Certificate.

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

CHARLES A. PINNEY, JR.,